Bankruptcy law update

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BANKRUPTCY LAW UPDATE

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BANKRUPTCY LAW UPDATE*

ISSUE DEFINITION

The *Bankruptcy Act*, R.S.C. 1985, c. B-3, is a commercial statute which provides for the orderly and equitable distribution of the assets of an insolvent person amongst the creditors. It also provides an opportunity for debtors to avoid bankruptcy by reorganizing their debts, with the permission of their creditors.

The *Bankruptcy Act* dates back to 1949 and was long overdue for an overhaul. Six omnibus reform bills were introduced in Parliament between 1975 and 1984 but none was passed into law. Three different advisory committees have made recommendations for amendments, none of which has been implemented. In 1988, the Department of Consumer and Corporate Affairs published proposed revisions to eight key areas of the *Bankruptcy Act*.

On 13 June 1991, Bill C-22, containing the proposed Wage Claim Payment Act (WCP Act) and amendments to the *Bankruptcy Act*, was introduced in the House of Commons. The bill received Royal Assent on 23 June 1992.

Many of the proposals put forward in the new legislation are based upon the reforms suggested by the Department in 1988. This paper presents the reforms in the *Bankruptcy and Insolvency Act* (the "Act").

* The original version of this Current Issue Review was published in November 1988; the paper has been regularly updated since that time.

BACKGROUND AND ANALYSIS

The movement in favour of revisions to the *Bankruptcy Act* began in 1970 with the publication of the Report of the Study Committee on Bankruptcy and Insolvency Legislation (known as the Tassé Report). The Committee urged the adoption of a revised statute in light of the many economic and social changes since the passage of the *Bankruptcy Act* in 1949. Bill C-60 was introduced in 1975 to implement the Report's recommendations. The Senate Committee studying the bill subsequently recommended many changes and the bill was allowed to lapse. Three more bills introduced in the Senate between 1978 and 1979 also died on the Order Paper. The Government introduced Bill C-12 in the House of Commons in 1980; however, second reading was delayed until 1983 and Parliament was dissolved before the Commons Committee completed its hearings. Bill C-12 was re-introduced as Bill C-17 in 1984, only to die on the Order Paper after second reading.

In June 1988, the Government published a document entitled "Proposed Revisions to the *Bankruptcy Act*." In this document, the Government opted to suggest reforms to eight key areas of bankruptcy law rather than to continue to present a completely new statute containing far-reaching reforms.

The *Bankruptcy and Insolvency Act*, like the 1988 proposals, contains reforms in the following areas of the law.

A. Wage Claims
B. Secured Creditors and Receivers
C. Commercial Reorganizations
D. Consumer Arrangements
E. Consumer Bankruptcies
F. Crown Priority
G. Unpaid Suppliers
H. Technical Changes

In the following text, the Act's provisions in each of these areas will be summarized and compared to previous attempts at reform.

A. Wage Claims

A major new revision in Bill C-22 was the proposed creation of a wage claim payment program, a fund to provide direct compensation for unpaid wages to terminated employees of companies which are bankrupt, being liquidated, or in receivership.

Under the *Bankruptcy Act*, unpaid wage claims in a bankruptcy were preferred to a maximum of $500 over the claims of general creditors. This form of priority status for wage earners was largely illusory since secured creditors ranked ahead of them in any distribution of property. Furthermore, even if moneys were available, they were normally paid some time after the date of bankruptcy. Another problem was that the amount of the priority was inadequate in light of current wage levels.

The idea for a government-administered fund dates back to 1975 and the first attempt to amend the Act. Bill C-60 had proposed to implement a Tassé Committee proposal by conferring a "super priority" status on unpaid wage claims up to $2,000, binding secured creditors as well as general creditors. Secured creditors objected to the proposal as a potentially serious dilution of their protected status and the Senate Banking, Trade and Commerce Committee, was of the opinion that super priority status for wages would be detrimental to a borrower's ability to obtain financing, especially in labour-intensive industries. Instead, the Committee recommended the creation of a government wage protection fund, made up of contributions from employers and employees, out of which outstanding wages of employees to a maximum of $2,000 could be paid immediately upon bankruptcy.

In 1980, Mr. André Ouellet, then Minister of Consumer and Corporate Affairs, appointed a small task force of bankruptcy experts to investigate the problem anew. The Landry Committee reported in 1981 that it was unable to determine the seriousness of the problem of unpaid wages, in view of the scarcity and incompleteness of reliable data on the number and value of unpaid wage-earner claims. The evidence they were able to collect, however, did verify that a

problem existed. Committee members noted that five West European countries -- the U.K., France, West Germany, Belgium and Denmark -- had all introduced a wage-earner protection scheme; this was also their recommended solution for Canada. They believed, however, that a permanent legislative solution could not be formulated until the size of the problem had been determined, and federal and provincial policies coordinated. Their final recommendation was an interim three-year solution during which unpaid wages should be covered by the Consolidated Revenue Fund up to a maximum of $1,000. To arrive at a permanent comprehensive wage protection system, the Committee recommended that federal-provincial meetings should take place.

The Committee's recommendations were not immediately accepted. The next bankruptcy bill, in 1984, had basically the same provisions for wage earners as Bill C-12 in 1980. In the event of a bankruptcy or receivership, Bill C-17 provided that a claim for wages up to a maximum of $4,000 would rank in priority over the claims of all secured creditors. The then Minister did not endorse the idea of a wage protection fund because of the lack of statistical data on the cost and the fear it would operate as a disincentive to employers to pay wages on time.

The new Progressive Conservative Minister, Michel Côté, decided to proceed with bankruptcy reform by amending the existing Act rather than by enacting sweeping reforms through a new statute. In March 1985 he appointed an Advisory Committee, chaired by Gary Colter of Peat Marwick Limited, to examine the bankruptcy system, assess possible reforms and recommend amendments. The Committee tabled its report in January 1986. It made the following recommendations with respect to wage-earner protection.

1. A fund should be established for the purpose of paying the arrears of wages of employees whose employers have been either declared bankrupt or put into receivership. Such a fund would be the best method of ensuring that employees of insolvent companies were promptly paid their arrears of wages.

2. The wage earner protection fund should be financed by contributions from employers and employees.

3. Employees related to the insolvent employer should not be entitled to any payments out of the fund.

4. Employees should be entitled to be paid the following:

- arrears of gross wages and commission earned within the six months preceding the insolvency;

- arrears of vacation pay earned within the 12 months preceding the insolvency;

- arrears of all amounts withheld from the employee such as pension benefits, and union dues;

- provided that the maximum payment should not exceed $2,000 per employee; and

- arrears of expenses incurred by the employee on behalf of the employer to a maximum of $1,000 per employee in the two months preceding the insolvency.

5. The Fund should be administered by the Unemployment Insurance Section of the Department of Employment and Immigration.

6. Payments to employees should be made by the trustee or receiver.

7. The fees and expenses of the trustee or receiver resulting from processing the special preferred claims of the wage earners should also be paid by the fund.

8. Any amounts paid by the fund should be subrogated as special preferred status claims under section 107 of the *Bankruptcy Act* ranking immediately after the costs of administration.

9. Any amounts due to employees for severance pay should remain as unsecured claims ranking with other unsecured claims against the employer.

The Department's June 1988 proposals differed from these recommendations of the Colter Committee in several respects. First of all, the program was to be financed entirely by the federal government rather than by employer and employee contributions. The Department also proposed that the Superintendent of Bankruptcy of the Department of Consumer and Corporate Affairs, rather than the Unemployment Insurance Section of Employment and Immigration, administer the fund.

The Department accepted the Colter Report's recommendation on monetary limits. The fund was to guarantee 90% of unpaid wages and vacation pay earned in the previous six

months, to a maximum of $2,000, and up to $1,000 for arrears of expenses incurred on behalf of the employer.

The purpose of a wage-earner protection program was to alleviate the immediate hardship experienced by unpaid wage earners upon the insolvency of their employer. Through expeditious payment of claims within prescribed limits, employees could meet their most immediate expenses until there was a cash flow from alternative employment or unemployment insurance. The certainty and the timeliness of a wage-earner protection program was lacking in the super priority proposal of previous bills. The available assets of the bankrupt might not have covered the amount claimed and there might have been a significant delay in payment pending the sale of the bankrupt's assets. In addition, serious difficulties might have arisen in the administration of the super priority proposal since it would have been a complicated task to allocate the burden of paying claims among the various secured creditors. It has also been argued that the creation of a super priority would have imposed an unexpected burden on a secured creditor and reduced the credit available to a labour-intensive industry.

The Report of the Advisory Council on Adjustment (the de Grandpré Report) endorsed the creation of a national wage earner protection fund to make payments of up to $4,000 to cover unpaid amounts owing to employees. The Council was of the opinion that the federal government should assume this obligation when the employer cannot pay. The Council went on to recommend that in the event the wage earner protection fund is not created, claims of wage earners should be given priority over all other claims in the disposition of assets of insolvent employers.

A working document prepared for, but not endorsed by, the Economic Council of Canada, favoured an expanded unemployment insurance program rather than the proposed protection fund. The author suggested that if UI eligibility was based on loss of wages, rather than loss of employment, it would encourage adjustment through the active involvement of employees. A wage protection fund, on the other hand, would be like a subsidy paid to the debtor firm and would enter into its adjustment decisions as a possible source of wage payments.

Bill C-22, as introduced at first reading, would have established a wage claim protection program pursuant to a new statute, the Wage Claim Payment Act. The bill would have

created a fund, financed by contributions from employers, from which employees could claim unpaid wages, vacation pay and salesperson's expenses in the event that an employer had become bankrupt, had been liquidated or had gone into receivership.

The amount of the benefit to be paid out of the fund would have been set at 90% of an employee's unpaid wages and vacation pay earned within the preceding six months, up to a maximum of $2,000 and 90% of salesperson's expenses unpaid during the same period, up to a maximum of $1,000. Pension contributions, severance and termination pay would not have been included. The program would have been administered by the Superintendent of Bankruptcy and benefits would have been paid out of the Consolidated Revenue Fund.

The program would have been financed by a payroll tax on employers equal to 0.024% of an employee's weekly insurable earnings under the *Unemployment Insurance Act*. The tax, which would have been imposed as of 1 January 1992, would have been collected jointly with the unemployment insurance program and was expected to cost employers about 10 cents per employee per week.

The concept of a wage protection fund was generally well received; however, the method of financing the fund was not. Business and institutions such as municipalities, hospitals, and school boards, whose employees would likely never have occasion to benefit from the fund, opposed the imposition of a payroll tax.

In its pre-study report on Bill C-22, the Standing Committee on Consumer and Corporate Affairs and Government Operations rejected the concept of a wage protection fund and recommended that workers' claims for unpaid wages be given priority over the claims of all other creditors, in the event of an employer's bankruptcy, liquidation or placement in receivership.

During clause-by-clause consideration of the bill in late 1991, the government proposed that the WCP Act be amended to defer the imposition of the tax for a period of one year and to allow the Governor in Council to adjust the percentage of the payroll tax to cover the payment of benefits under the program.

After procedural difficulties in the Standing Committee, the Government reconsidered its position on the WCP Act and, in May 1992, the Minister of Consumer and Corporate Affairs announced that it would be withdrawn.

Amendments to the existing preferred creditor provisions were put forward. Thus, the new Act maintains preferred creditor status for unpaid wage claims and salesperson's expenses where an employer is bankrupt, but the amount of the claim is raised from $500 to $2,000 for wages and from $300 to $1,000 for salesperson's expenses. Where an insolvent employer makes a proposal to reorganize his or her business, unpaid wages up to $2,000 and salesperson's expenses up to $1,000 are to be paid immediately after court approval of the proposal.

When Bill C-22 received Royal Assent on 23 June 1992, the Minister of Consumer and Corporate Affairs announced that he intended to refer the matter of wage claims for reconsideration by a special Joint Committee of the House of Commons and the Senate, which would report by the summer of 1993. This Committee was never established.

B. Secured Creditors and Receivers

An amendment to regulate receivers has been part of bankruptcy reform proposals since 1975. In the common law provinces, a receiver is a person who, by agreement or court order, has taken possession of all or substantially all of the debtor's assets. Under the usual terms of commercial financing agreements, which include debentures, loans under the *Bank Act*, floating charges and conditional sales contracts, on default of payment the secured creditor may appoint a receiver to take possession of the debtor's assets and sell them in order to pay off the debt. In Quebec, a similar function is performed by an agent appointed either by a trustee under a trust deed issued pursuant to the provincial *Special Corporate Powers Act* or by a bank to enforce a *Bank Act* security.

There were no provisions in the *Bankruptcy Act* to govern the conduct of secured creditors and receivers, even though the interests which the receiver represented were in conflict with those of the debtor and the unsecured creditors. Because the bankruptcy administration is generally subject to the prior rights of secured creditors, a receiver could be appointed to take

possession of all the assets of the estate before or after the date of bankruptcy, leaving few if any assets to be administered by a trustee in bankruptcy. There was no mechanism to permit either the unsecured creditors or the Superintendent of Bankruptcy to maintain any surveillance over the receiver's conduct to ensure that the receiver acted fairly, given the residual claims of all subordinate creditors. To remedy this, the reforms in the Act are aimed at disclosure, accountability and preventing conflicts of interest in a receivership situation.

The Act requires receivers of insolvent debtors to act in good faith and to deal with the insolvent person's property in a commercially reasonable manner. This standard of conduct was first suggested in the 1975 Senate committee report on Bill C-60 and has been part of all subsequent bills. It is basically a declaration of present case law on a receiver's fiduciary duty. The revisions give the courts jurisdiction to review the actions of a receiver.

Notice of the receiver's appointment has to be given to the debtor, other creditors and the Superintendent within ten days. Additional information in the form of a receiver's statement has to be furnished to the insolvent person or trustee, and on request, to creditors. Interim reports of the receiver's administration and a copy of his or her final report and statement of accounts has to be provided to the Superintendent, the trustee, or insolvent person and to creditors.

A secured creditor wishing to enforce a security has to give at least ten days' prior notice. This gives the debtor an opportunity to file a notice of intention to file a proposal, thus providing a 30-day breathing space to try to negotiate a reorganization plan with creditors and avoid bankruptcy.

To ensure accountability, the Act empowers a court to order that a receiver pass his or her accounts. To avoid conflicts of interest, it prohibits a person who was a director, officer, employer, employee, auditor, accountant, or solicitor of a debtor within the two preceding years from acting as a trustee without court approval. Nor can persons related to those persons be permitted to act without court approval. A person who is a trustee, receiver or liquidator for a person related to the debtor cannot act as a trustee in bankruptcy unless he or she makes full disclosure of that fact and of the potential conflict of interest. Trustees cannot act as receivers of

the property unless they first obtain an independent opinion on the validity of the security and then inform creditors of this and of the basis of their remuneration as receivers. These accountability and conflict of interest proposals have been a part of every bill since C-60, implementing the Tassé Report's recommendation in this regard.

C. Commercial Proposals

Part III of the *Bankruptcy Act* allowed the debtor to make a "proposal" to creditors, thus effectively freezing the enforcement remedies of unsecured creditors while attempts were made to reorganize the business.

The proposal (or reorganization) had to provide for payment of the claims of creditors having a priority under the Act and the trustee's fees and disbursements. The proposal had to be accepted by a special resolution of the unsecured creditors; this required the agreement of creditors representing 75% of the value of the claims and a majority in number of the creditors voting. If the creditors did not approve the proposal, the debtor was automatically declared bankrupt. A proposal that the creditors did accept also had to be approved by the court.

1. Stays of Proceedings

The *Bankruptcy Act* put only minimal restraints on secured creditors and failed to ensure that debtors had the opportunity to negotiate proposals with their creditors. The new Act ensures that debtors have time to prepare and negotiate appropriate reorganization proposals. Thus, a 30-day statutory stay of proceedings binding on both secured and unsecured creditors is established. This period can be extended by court order for periods of up to 45 days each, provided that all extensions do not exceed five months. Then, upon the filing of the proposal, a further stay is imposed on all creditors pending a creditors' meeting to be held within 21 days. Should the debtor fail to file a reorganization plan within the 30-day or the extended time period as the case may be, the debtor is deemed to have made an assignment in bankruptcy.

The Standing Committee on Consumer and Corporate Affairs and Government Operations supported the concept of allowing a debtor to extend the stay period beyond six months, subject to creditor approval. This, however, was rejected by the government.

2. Protection for Creditors

To protect creditors during the stay period, the court has authority to appoint an interim receiver of the debtor's estate. The court can direct the interim receiver to take possession of the debtor's property and exercise control over such property and business.

A creditor can also apply to the court to have a stay lifted where he or she is materially prejudiced by its continuance.

3. Voting

The new revisions lower the required majority from 75% of the value of claims to 66 2/3% in order to allow more proposals to succeed. The secured creditors provided for in a proposal can vote by class and no one secured creditor class can defeat a proposal. Secured creditors can be segregated into classes for the purpose of voting on a proposal. They will be included in the same class if their interests are sufficiently similar to give them a commonality of interest, taking into account: (a) the nature of the debts; (b) the nature and priority of the security; (c) the remedies available to the creditors in the absence of the proposal and the extent to which they would recover their claims by exercising those remedies; and (d) the treatment of the claims under the proposal and the extent to which the proposal would satisfy those claims. For the purpose of voting, all unsecured creditors constitute one class unless otherwise designated. A proposal will be deemed to be accepted if a majority in number and two-thirds in value of all unsecured creditors voting on the proposal vote for acceptance. Where a class of secured creditors votes against the proposal, the proposal will go forward but will not apply to those classes of secured creditors who opposed it. Automatic bankruptcy will follow only where unsecured creditors reject the proposal.

4. Approval by the Court

Under the new Act, all commercial proposals must be approved by the court. However, the court will not approve a proposal unless it includes full payment within six months of all outstanding arrears of source deductions for federal income tax, Canada Pension Plan and unemployment insurance, and similar provincial liabilities. In addition, the debtor cannot have defaulted in paying any of these amounts that become due after the proposal is filed. A proposal will also have to provide for the payment of outstanding wage claims up to the maximum amounts provided in the Act and for the payment of compensation to a landlord whose commercial lease has been repudiated as a result of the proposal. Preferred creditors will continue to be protected by the requirement that a proposal must provide for their payment in full, before any payment to ordinary creditors.

In its pre-study report, the Standing Committee recommended that there be no limitation period on the payment of source deductions.

5. Limitations to Certain Rights

The Act also contains protections designed to enable the debtor to carry out the proposal successfully. Where proceedings are ongoing or the proposal is in effect, no person can claim an accelerated payment, terminate an agreement or a lease, or discontinue public utility services to a debtor merely on the grounds the debtor is insolvent, has filed a proposal or that a proposal is in effect, or because rent or utility charges were in arrears prior to the filing. A creditor, landlord, or public utility can apply to the court for an order that the prohibition be lifted. A debtor has the right to repudiate a commercial lease subject to the right of the landlord to apply to the court for an order refusing termination.

During the 30- and 21-day periods and the first-six months that a proposal is in effect, the Crown cannot enforce a statutory garnishment right under the *Income Tax Act* so long as current remittances are kept up to date. Repayment of any arrears of source deductions will be provided for in the proposal so that such amounts will be fully paid at the end of the six months following the stay periods.

The Act allows persons other than a debtor to put forward a proposal. These include the trustee of the bankrupt estate, a receiver, and a liquidator.

D. Consumer Proposals

An insolvent consumer could have made a proposal under Part III of the *Bankruptcy Act* in the same way as a commercial debtor. However, the procedures were too expensive and too cumbersome for most consumers. Since 1975 proposed amendments have included a separate system for consumer proposals which would be simpler and less expensive.

The new revisions generally adopt the recommendations of the Colter Report. A "consumer debtor" is defined as a natural person whose debts are less than $75,000 (excluding a mortgage on his principal residence). A consumer debtor can present a proposal to all his creditors applicable to all his debts, providing for their extension or reduction, or both. Its maximum duration is five years.

A consumer debtor who wishes to make a proposal has to obtain the assistance of an administrator, defined in the Act as a trustee or a person designated by the Superintendent of Bankruptcy to administer consumer proposals. The administrator prepares the proposal, investigates the consumer debtor's property, and financial affairs and provides counselling to the debtor in accordance with directives issued by the Superintendent.

On the filing of a consumer proposal, actions by all unsecured creditors are stayed until the proposal is fully performed, withdrawn, refused or annulled, as the case may be. Secured creditors, however, are able to realize on their securities.

After a proposal has been filed, either the official receiver, or creditors having at least 25% in value of the claims against the debtor, can call a meeting of creditors to vote on the proposal. If neither the official receiver nor the creditors requires a meeting, the proposal is deemed accepted. If a meeting of creditors is held, voting to accept or refuse a proposal is by ordinary resolution with all creditors voting as one class on the basis of one dollar equals one vote.

The necessity of having court approval for a proposal once it has been accepted by the creditors is waived. It is still available, however, should any creditor wish to make application to the court.

Under the *Bankruptcy Act*, rejection of a proposal by the creditors triggered automatic bankruptcy. Under the new Act, a consumer debtor will not become automatically bankrupt for defaulting under a consumer proposal or if the proposal is withdrawn, annulled, or rejected by the creditors. Where there is a default under a consumer proposal, the court can annul the proposal; where there was a default to the extent of three months' payments, however, a consumer proposal will be automatically annulled. Upon annulment, the rights of the creditors are revived.

Other protections for the consumer debtor include prohibitions against public utility shut-offs, termination of leases and agreements, and employee dismissals based only on the fact that the consumer or employee has made a proposal.

This reform of consumer proposals does not go as far as previous bills because a secured creditor, notwithstanding the filing of the proposal, will still have the right to realize or otherwise deal with its security. In previous bills, creditors who had a security interest in personal property were automatically included in the consumer proposal unless more than one-third of the debt was owing and the creditor expressed in writing his decision not to participate. If the secured creditor chose to opt out and to realize on the collateral, it would not be able to claim any deficiency between the proceeds realized on the sale and the amount owing. Previous bills also provided some guidelines with respect to realization: the creditor would have been obliged to act honestly and in good faith, to deal with the property in a commercially reasonable manner and to make a report of all his dealings to the administrator overseeing the proposal. The new revisions would neither restrict the right of the secured creditor to realize his security interest nor bar a deficiency claim. The Colter Report claimed that disallowing deficiency claims might lead to a restriction of credit to the lower socioeconomic strata of society.

E. Consumer Bankruptcies

1. Summary Administration

Under the *Bankruptcy Act*, two types of administration were applicable to the estates of individual bankrupts: summary administration and ordinary administration. Summary administration applied only where the assets available for distribution to the unsecured creditors did not exceed $500. Summary administration procedures were somewhat streamlined and less expensive. Publication of the notice of bankruptcy was not required and inspectors need not be appointed.

The new Act expands the summary administration eligibility to cases where the amount of unsecured assets available for distribution is less than $5,000 (or such other amount as prescribed by regulation), rather than $500. The Colter Report had recommended that the governing factor be the amount of liabilities rather than the amount of assets; otherwise, it claimed, it would be too easy for a debtor to dispose of assets in order to avoid a thorough investigation of his affairs under the ordinary administration. In 1988, when the Department presented proposals for amending the summary administration criteria, it noted that the absence of a limit on debt size in order to qualify for summary administration would not lead to abuses, as full examination of debtors could occur in any event.

The Act contains additional measures that would further streamline the summary administration process. Among these are: combining the estates of related persons, allowing the deposit of all summary administration moneys for estates in one trust account, combining notices of bankruptcy and discharge applications and prescribing procedures for taxation and the trustee's discharge by regulation.

2. Automatic Discharge

Another reform is an automatic discharge, nine months after the bankruptcy, for first-time consumer debtors, unless such discharge is opposed by the trustee, a creditor, or the Superintendent or the bankrupt fails to obtain counselling. Automatic discharge was recommended

by the Colter Committee to eliminate the expense of discharge proceedings. As it stands now, for debts and liabilities to be released, the bankrupt must make an application for discharge to a court.

In its pre-study report, the Standing Committee on Consumer and Corporate Affairs and Government Operations supported the concept of automatic discharge but recommended that all consumer bankrupts be required to receive financial counselling before being discharged from bankruptcy. The Act as passed reflects this recommendation.

Previous bills provided for an automatic discharge of the consumer debtor after either ninety days (Bill C-60) or six months (Bills S-9, S-11, C-12, C-17) from the date of the bankruptcy order unless a caveat was filed indicating the Bankruptcy Administrator had reason to believe that the bankrupt had substantially aggravated his insolvency by reckless business conduct, gross incompetence or carelessness or similar means, or that he had committed specified bankruptcy offences. If not withdrawn or set aside, the caveat would have effect for five years.

The *Bankruptcy Act* stipulated that an order of discharge did not affect certain types of debts, such as debts for "goods supplied as necessaries of life." The Act deletes that particular debt from the list of undischarged debts.

The Tassé Committee had recommended that the only debts not subject to discharge should be a fine or penalty imposed by a court and the dividend that a creditor without notice of the bankruptcy would have been entitled to receive. The Committee had also recommended that the release of a debtor be unconditional and should take effect as of the date of bankruptcy. A final recommendation in each of the previous bills was that power be given to the court to revive all debts from which a bankrupt had been released within five years after another bankruptcy, where the debtor had abused the bankruptcy process to the detriment of his creditors.

F. Crown Priority

Section 136 of the *Bankruptcy Act* gave a preferred ranking to the federal and provincial governments in the distribution of the proceeds realized from the property of the bankrupt. To add to this statutory priority, the federal government and most provincial governments have created statutory deemed trusts or deemed security interests intended to rank in

priority over the claims of secured creditors. The deemed trust device effectively circumvents section 136(1) because section 67 of the *Bankruptcy Act* excludes from a bankruptcy all property held by the bankrupt in trust for any other person. The federal government has used this legal fiction in respect of claims for amounts deducted from employees under the *Canada Pension Plan*, the *Unemployment Insurance Act* and the *Income Tax Act*. Provinces have created statutory deemed trusts and liens to cover amounts owing for wages, vacation pay and sales tax.

A 1989 Supreme Court of Canada decision put an end to this practice by the provinces, however. In *The Queen* v. *Henfrey Samson Belair Ltd.*, it was held that a statutory Crown trust created by provincial legislation is not a trust for the purposes of the *Bankruptcy Act* unless it meets the requirements of a trust under general principles of law. Because the trust property in this case was not identifiable or traceable but rather mingled with other money and converted to other property, the trust had ceased to exist. As McLachlin J., writing for the majority, stated:

> ... the definition of trust which is operative for purposes of exemption under the *Bankruptcy Act* must be that of the federal Parliament, not the provincial legislatures. The provinces may define "trust" as they choose for matters within their own legislative competence, but they cannot dictate to Parliament how it should be defined for purposes of the *Bankruptcy Act*...

This decision significantly alters the position of the provincial Crown in a bankruptcy but does not apply to the federal Crown. Thus the federal government can continue to rely on a statutory deemed trust, as well as a priority under section 136, while the provinces only have their section 136 priority.

Both the Tassé Committee and the Colter Committee recommended the abolition of Crown priority but for different reasons. The Tassé Committee was of the opinion that the public treasury was in a better position than anyone to bear the inevitable losses of bankruptcy because it could spread the burden of tax left unpaid by the bankrupt over all the tax paying public. The primary concern of the Colter Committee was the uncertainty in the distribution of a bankrupt's property created by the proliferation of statutory deemed trusts and liens. The requirement that

claims of the Crown be paid in full before any distribution to the unsecured creditors frequently prevents an effective reorganization. Both committees pointed out that the apathy of unsecured creditors in the administration of an estate in bankruptcy is due in large part to the Crown priority. The Crown itself seldom takes an active part in the proceedings.

The Colter Committee recommended that the elimination of the Crown priority should include all provincial and federal legislation purporting to give a priority, whether by way of security, statutory trust or lien or otherwise for any debt not contractually incurred.

The Act eliminates preferred creditor status for the Crown under section 136, but not statutory security interests. Statutory security interests have to be registered. Statutory trusts have to meet the requirements of a normal trust to be recognized but an exemption is made for UI, CPP, QPP, and income tax (including Quebec income tax) source deductions.

All the bills from C-60 to C-17 would have continued preferred status to claims of the Crown but restricted the amount to the cash on hand at the date of bankruptcy. In practice, this would also have eliminated the preferred status and relegated the Crown to the position of an ordinary creditor.

The Economic Council of Canada working document that evaluated the reform package was in favour of maintaining Crown priority. It argued that neither the Crown nor unpaid suppliers should act as a source of financing for businesses and infringe on the role of investors and financial intermediaries.

Taking a position similar to that of the Colter Committee, the Standing Committee recommended that all Crown priorities be completely abolished and that Crown claims should rank as unsecured claims.

G. Unpaid Suppliers

The idea of providing protection to unpaid vendors is not a new concept in Canadian law. A provision relating to unpaid suppliers has been included in the *Civil Code* of Quebec as articles 1998 and 1999 since 1886 and was proposed in the 1970 Tassé Report.

The *Civil Code* allows an unpaid vendor to repossess his or her goods within 30 days in the case of insolvent traders. The right to repossess is subject to four conditions:

1. The sale must not have been made on credit;
2. The goods must still be entire and in the same condition;
3. The goods must not have passed into the hands of a third party who has paid for them; and
4. The right must be exercised within 30 days after delivery.

The Tassé Committee recommended that a similar provision be added to the *Bankruptcy Act*. The Committee was of the opinion that it was just and reasonable to recognize the rights of an unpaid vendor of merchandise over the rights of other creditors. The Committee also believed that adding such rights would promote uniformity in the law across Canada.

The recommendations of the Tassé Report were acted upon in 1980 when the Honourable Judy Erola, then Minister of Consumer and Corporate Affairs, stated that unpaid suppliers of merchandise should be allowed to recover their goods. The Minister discussed a proposed amendment to Bill C-12 which would have allowed unpaid suppliers to recover any merchandise delivered within 10 days prior to a bankruptcy if a claim was made within 30 days of the triggering event.

Bill C-17 in 1984 would also have given unpaid suppliers the right to repossess their goods. An unpaid supplier could have demanded the return of the goods if they were delivered within 10 days of the insolvency and if the demand was made within 30 days of the insolvency. The goods would have had to be identifiable and not re-sold, or subject to any agreement for sale or a conditional sales agreement.

The Colter Committee considered protecting unpaid suppliers, but felt that this would be inequitable and prejudicial to other unsecured creditors. If unpaid suppliers were to receive any special protection, the Committee was of the opinion that it was for the provinces to legislate and not the federal government.

The 1988 Departmental proposals contained a repossession right. The Department was of the view that unpaid suppliers required special protection as they were often small businesses, which generally had only ordinary creditor status in the bankruptcy of their customers. A right to repossess unpaid-for goods would also remedy the inequity which results when debtor-businesses, just before bankruptcy, receive inventory which they use to pay secured creditors at the expense of the business that supplied the merchandise.

The Economic Council of Canada working document also recommended a priority for suppliers over other creditors within a certain time period. Outside that period, business claims, like all other claims, would be subject to the "first in, first out" rule.

In its pre-study, the Standing Committee on Consumer and Corporate Affairs and Government Operations favoured a priority for unpaid suppliers but recommended that the priority should apply in cases where goods were delivered within the 15 days prior to the purchaser's bankruptcy or placement in receivership and where the demand for repossession was made within 15 days after such an event.

The new Act gives unpaid suppliers the right to repossess merchandise delivered to a purchaser who becomes bankrupt or goes into receivership. A number of conditions would apply to this right. First, the supplier has to make a written demand for the goods within 30 days after delivery. Second, the purchaser has to be bankrupt or in receivership at the time the demand is made. Third, the goods have to be in the possession of the receiver, trustee or purchaser, and must be identifiable and not fully paid for, in the same state as they were on delivery and not resold at arm's length or made subject to any agreement for sale. The right to repossess the goods expires if not exercised within 10 days after it has been confirmed by the trustee, receiver or purchaser.

Where the goods have been partly paid for, a supplier has the right to repossess a portion of them, proportional to the amount owing, or to repossess all the goods after repaying the amount of any partial payment previously received.

The supplier's right to repossession ranks ahead of any other claim in respect of those goods and a supplier is not precluded from exercising any rights available under provincial law.

The new Act also provides a special right for farmers, fishermen and aquaculturists who deliver their farm and fisheries products to a purchaser who subsequently becomes bankrupt or is placed in receivership. Where such products are delivered within 15 days prior to the bankruptcy or receivership and the farmer, fisherman or aquaculturist files a claim for any unpaid amount in respect of those products within 30 days thereafter, the claim is secured by a charge on all of the inventory held by the purchaser. This charge takes priority over all other rights or charges against that inventory except a supplier's right of repossession.

H. Technical Changes

The new Act contains a number of technical amendments to the law. The duties and responsibilities of the various administrative officials are expanded and updated, streamlining many of the procedures required by the Act. Several points of clarification are suggested, particularly with respect to definitions, loopholes are tightened, and outdated sections have been repealed. At least two of the changes have significant policy content. One is a provision that creditors should have votes in proportion to the dollar value of their claim. This amendment was part of all of the previous bills and was endorsed by the Colter Report. It appears to add a greater measure of equity to the system. Another policy change gives the court the discretion to impose a fine, or order community work or payments to the trustee in lieu of imprisonment for a bankruptcy offence. This is in keeping with current thinking on appropriate punishment for non-violent white-collar crime.

I. Operation of the Law

The *Bankruptcy and Insolvency Act* requires the statute to be reviewed by a parliamentary committee three years after the section authorizing the review comes into force.

In anticipation of the review, the government set up the Bankruptcy and Insolvency Advisory Committee (BIAC). The BIAC, which is composed of government and private-sector participants, is designed as a forum in which to discuss and establish priorities for insolvency reform and to develop recommendations for placing before the parliamentary committee. A series

of working groups to examine various areas of bankruptcy law have been established under the auspices of the BIAC.

In 1994, the BIAC endorsed a number of reform proposals in the areas of consumer bankruptcies and proposals, commercial reorganizations, international insolvencies, stockbroker insolvencies, priorities and privileges, directors' liability and legislative and technical issues.

For example, joint consumer proposals, as well as the exemption from the bankruptcy process of some benefits, such as GST refunds, were suggested. For commercial reorganizations, it was recommended that there be a tightening of the eligibility requirements for disclaiming a lease. The ability to reorganize under the *Companies' Creditors Arrangement Act* would be retained.

It was also suggested that the Crown be subject to the same stays of proceedings, priorities and right to distribution as other creditors. The BIAC endorsed the addition of provisions to the *Bankruptcy and Insolvency Act* to facilitate the administration of cross-border insolvencies.

Proposals were also made in connection with the insolvency of securities firms.

Changes were suggested in the area of directors' liability. Corporate directors would be permitted to propose settlements for certain liabilities as part of a reorganization proposal. In addition, directors would be permitted to obtain a temporary stay of proceedings.

A number of legislative and technical issues were considered, For example, it was suggested that railways and municipal corporations not be brought under the BIA.

The BIAC process was followed by the preparation of amendments to the *Bankruptcy and Insolvency Act*. These amendments were introduced in the House of Commons as Bill C-109 on 24 November 1995. The bill, however, died on the Order Paper with the ending of the parliamentary session.

On 4 March 1996, Bill C-5 was introduced in the House of Commons. The bill, which is the same as Bill C-109, would amend the *Bankruptcy and Insolvency Act*, the *Companies' Creditors Arrangement Act* and the *Income Tax Act*.

Among other things, Bill C-5 proposes amendments to the *Bankruptcy and Insolvency Act* in the following areas:

- **the licensing and regulation of trustees;**
- **liability of trustees for environmental damages and claims;**
- **liability of directors and stays of action against directors during reorganizations;**
- **compensation for landlords where leases are disclaimed in a reorganization proposal;**
- **procedures in consumer proposals;**
- **consumer bankruptcies;**
- **student loan debts;**
- **requirements for bankrupts to pay part of their income to the bankruptcy estate;**
- **international insolvencies;**
- **securities firms insolvencies; and**
- **technical matters.**

The bill would also make a number of important amendments to the *Companies' Creditors Arrangement Act*, to align provisions of that Act more closely with those of the BIA.

CHRONOLOGY

1919 - The *Bankruptcy Act* was enacted by Parliament in the session of 1919 (9-10 Geo. V, c. 36), and came into force on 1 July 1920. The Act and amendments thereto were consolidated and revised and approved as R.S.C. 1927, c. 11.

1949 - The present *Bankruptcy Act* was enacted.

1966 - The Act was amended by *An Act to Amend the Bankruptcy Act*, S.C. 1966-67, c. 32 to increase the Superintendent's investigatory powers, to make stricter the rules relating to fraudulent preferences and to add a new Part X concerning consumer arrangements by way of extension.

1966 - The Study Committee on Bankruptcy and Insolvency Legislation (the Tassé Committee) was appointed to undertake an in-depth study of Canadian bankruptcy law.

1970 - The Tassé Report was published, recommending the enactment of a completely new bankruptcy and insolvency statute that would establish an integrated and comprehensive bankruptcy system.

5 May 1975 - Bill C-60 was tabled by the Hon. Herbert Gray, then Minister of Consumer and Corporate Affairs. After first reading in the House of Commons, the bill was referred to the Senate Committee on Banking, Trade and Commerce. The Committee recommended 139 changes to the bill.

21 March 1978 - Bill S-11 was introduced in the Senate. It contained 128 of the amendments recommended by the Senate Committee reviewing Bill C-60. Second reading followed on 4 April 1978 but the bill was not passed.

27 February 1979 - Bill S-11 was re-introduced in the Senate as Bill S-14. It progressed to second reading on 13 March 1979 and died on the Order Paper with the dissolution of the 30th Parliament on 26 March 1979.

8 November 1979 - Bill S-14 was re-introduced in the Senate as Bill S-9 during the 31st Parliament. It died on the Order Paper on 13 December 1979 after first reading.

16 April 1980 - Bill C-12 was introduced in the House by then Minister of Consumer and Corporate Affairs, André Ouellet. The bill received second reading on 26 September 1983 and was referred to the Commons Committee on Finance, Trade and Economic Affairs. Parliament was prorogued before the Committee completed its hearings.

1981 - A committee chaired by Raymond Landry of the University of Ottawa was asked to make recommendations on wage protection.

The report of the Committee on Wage Protection in Matters of Bankruptcy and Insolvency was published in October 1981.

31 January 1984 - Bill C-17 was introduced in the House by then Minister of Consumer and Corporate Affairs, Judy Erola. It was essentially the same as the previous bill except for some technical amendments. Further amendments were tabled on 28 May. The bill died on the Order Paper after second reading.

March 1985 - An Advisory Committee composed of trustees and lawyers was appointed by the then Minister of Consumer and Corporate Affairs, Michel Côté, to examine the bankruptcy system, assess possible reforms and recommend amendments. The report of the Committee (the Colter Report) was tabled in January 1986.

September 1986 - A discussion paper on Bankruptcy Act Amendments was published by the Legislative Review Branch of the Department of Consumer and Corporate Affairs, indicating its recommendations based on the findings of the Colter Report and its own consultations with interest groups and with the provinces.

1988 - A document entitled "Proposed Revisions to the *Bankruptcy Act*" was published by the Department. It proposed an initial package of selected reforms in eight areas of the law.

March 1989 - The Report of the Advisory Council on Adjustment (the de Grandpré Report) recommended that the Department expedite amendments to the *Bankruptcy Act* to create a national wage earner protection fund. The Advisory Council was created in January 1988 to examine adjustment issues arising from the Free Trade Agreement.

March 1990 - A working document prepared for the Economic Council of Canada by B.-M. Papillon did not support the idea of a wage earner protection fund but instead proposed changes to the unemployment insurance program. It also advocated a "first in, first out" rule for all creditors (secured and unsecured), except for supplier and Crown claims.

13 June 1991 - Bill C-22, containing amendments to eight key areas of bankruptcy law, was introduced in the House by the Minister of Consumer and Corporate Affairs, Pierre Blais.

7 October 1991 -	The House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations tabled its report on the pre-study of Bill C-22.
5 November 1991 -	Bill C-22 received second reading and was referred to the Standing Committee on Consumer and Corporate Affairs and Government Operations for clause-by-clause consideration.
23 June 1992 -	Bill C-22 received Royal Assent. It will come into force on proclamation.
	The Minister of Consumer and Corporate Affairs announced that he intends to propose that a Special Joint Committee of the Senate and the House of Commons be established to examine and report on the matter of unpaid wage claims, by the summer of 1993.
30 November 1992 -	Provisions of the *Bankruptcy and Insolvency Act* came into force.
24 November 1995 -	**Bill C-109, containing amendments to the *Bankruptcy and Insolvency Act*, the *Companies' Creditors Arrangement Act* and the *Income Tax Act*, was introduced in the House of Commons. It died on the Order Paper after first reading.**
4 March 1996 -	**Bill C-5, which is essentially the same as Bill C-109, was introduced in the House of Commons.**
27 May 1996 -	**Bill C-5 received second reading and was referred to the House of Commons Standing Committee on Industry for clause-by-clause consideration.**

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